ETF Specialist

Will Active ETFs Make Mutual Funds Obsolete?

By Sonya Morris, CFA | 12-06-07 | 03:00 PM

Proponents of exchange-traded funds have heralded the coming of active ETFs for years now. But last week, PowerShares took an important step toward making them a reality. The firm asked the SEC to approve four active ETFs--three stock funds and one bond fund. In doing so, the firm won the race to submit the first prospectus for an active equity ETF. (There are a handful of active bond ETFs awaiting SEC approval.)

My initial take: While these proposed ETFs are interesting, don't expect your favorite active manager to launch an ETF anytime soon. Two of the three PowerShares stock funds have adopted an approach that's likely to prove too limiting for all but the most hands-off managers. And while the third fund's strategy is more akin to that of a traditional, actively managed offering, it will target one of the most efficient, liquid parts of the market, where active managers have had a tougher time adding value.

The Dilemma

Active stock ETFs pose a dilemma. An ETF must reveal its holdings every day to facilitate the creation and redemption of fund shares, a process that helps to keep the fund's price in line with its net asset value (NAV). Understandably, active equity managers are reluctant to do that for fear that they will tip their hand and give rivals the chance to profit by trying to front-run trades that may be in process.

There have been a number of asset managers and consultants seeking a way to get around the transparency issue, but PowerShares is the first one to hand a prospectus over to the SEC for approval.

PowerShares' Solution

The firm filed for three active equity ETFs. Notably, none of these funds will track an index, a distinction that sets them apart from virtually every other ETF.

The first two--PowerShares Active AlphaQ and PowerShares Active Alpha Multi-Cap--are basic quant funds. A computer model ranks stocks, and the funds will include the 50 highest-ranked stocks in their respective universes, equally weighting them. Unlike index ETFs, which keep trading to a minimum, these funds can make up to three trades on the last business day of the week. Those trades won't be revealed until the portfolio is posted on PowerShares' Web site the following business day.

The third fund, PowerShares Active Mega-Cap, goes a step further. While management will reference quantitative models, it will have room to apply judgment. Furthermore, management can use derivatives or hold cash on occasion. Its holdings will be published each day, but the managers can trade at any time. As such, the published holdings may not always correspond exactly with what's in the portfolio.

In a nutshell, PowerShares is using a few workarounds to resolve the transparency issue. With the Alpha funds, it's reducing the risk of big deviations from NAV by limiting trading to a single day. In other words, let the manager be active, but not too active. With the Mega-Cap fund, it's setting the manager loose, so to speak, but in what's arguably the most-liquid segment of the stock market, where the impact of front-running isn't as pronounced.

Problem Solved?

While this is certainly a step toward a truly active ETF, I don't think we'll see a flood of active managers launching ETFs. For one thing, few managers would be willing to restrict their trading to a single day, as the first two ETFs require. In fact, most mutual funds of any size take more than a day to build a position. And managers would also be reluctant to post their fund holdings every day, particularly while they were still building a position. So I don't look for many active managers to try to imitate these funds. That said, I wouldn't be surprised to see ETF providers roll out similar quantitative active ETFs in a bid to get a piece of the action.

Furthermore, although these proposed funds are breaking new ground in the ETF arena, it's not clear how different they will be from the mutual fund competition. For example, the first two are essentially quantitative funds, an area where investors already have some compelling options, including funds run by Bridgeway, Vanguard, and Janus' INTECH team. (Click here for more on our favorite quant funds). Quantitative strategies have been around for a while, and more fund shops have added quant funds to their lineups. Our favorite quant funds have proven track records (which the proposed ETFs by definition will lack), sensible strategies, and low fees. Expenses are key because most quant funds don't try to hit the ball out of the park, rather they try to grind past the competition over time. Because most quant funds aim for relatively modest excess returns, they increase their chances of success by keeping fees low. PowerShares hasn't yet revealed the expense ratios of the proposed ETFs, but I hope they'll make them competitive with the quantitative mutual funds that are already on the market, at the very least.

Granted, the tax-efficient structure of ETFs holds promise for limiting taxable gains. But that would have less impact on low-turnover strategies--like those employed by the team at Dodge & Cox Stock (DODGX) or the managers of Davis NY Venture (NYVTX) for example--many of which have generated competitive tax-adjusted long-term returns. And while fast-trading managers would benefit the most from ETF tax efficiency, they would pose difficulties when it comes to transparency. That is, for high-turnover portfolios, there are likely to be more discrepancies between the disclosed holdings and the actual portfolio.

Finally, it could still take some time for the SEC to give these funds the green light. Bear Stearns (BSC) filed for an actively managed bond ETF back in March and it has not yet been approved. So although this is a ground-breaking filing, it's not clear if active ETFs will have a big impact on the ETF market anytime soon.

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